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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1950

Nos. 211, 212

NIAGARA HUDSON POWER CORPORATION,
Petitioner,

v.

M. VICTOR LEVENTRITT

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

M. VICTOR LEVENTRITT

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT

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BRIEF FOR RESPONDENT

Opinions Below, Jurisdiction and Statute Involved

These are set forth in the Government's brief at 1-4.

Questions Presented

The S. E. C. extinguished the option warrants herein without compensation. Was this not error of law, in the light of the following?

1. The S. E. C. refused to give recognition to the acknowledged value inhering in the warrants with their perpetual call feature.

2. The S. E. C. failed to apply to the option warrants the appropriate tests of value.

3. The S. E. C. wholly ignored the fair market value of the option warrants.

Statement

This case involves one of two plans filed under Section 11 (e) of the Public Utility Holding Company Act of 1935 by Niagara Hudson Power Corporation, a registered holding company. This plan contemplates dissolution of Niagara Hudson and the distribution of its assets among its stockholders after provision for the discharge of its indebtedness. The principal question dealt with by the Court of Appeals, was whether, under the "fair and equitable" standard of Section 11 (e), the Commission erred in extinguishing the Class B stock option warrants of Niagara Hudson without compensation. There are outstanding warrants to buy almost 500,000 shares of common stock. Each warrant gives the holder a perpetual right to call upon the company to issue 1⅛ shares of common stock for $50; i. e. a "call" on the common shares at $42.86 a share. The stock of Niagara Hudson is listed and actively traded on the N. Y. Curb Exchange and has recently been selling for between $15.50 and $16 a share or roughly ⅜ of the option price. The "high" price for the year to date has been 17⅞, the "low" 12½, a range of from 42% to 32% of the option price.

The warrants also were listed on the N. Y. Curb Exchange until 1949, when the Commission approved the plan providing for their extinction without compensation. The annual price range of the common stock and the option warrants from 1929 to 1949 is set forth at R. 90. The

relationship of the annual mean prices is depicted in Chart A at the end of this brief. Since the Commission has objected at footnote 17, page 33 of its brief to the use of such "a deceptively simple chart" we have also annexed Chart B at the end of this brief, using quarterly closing prices for the period 1937 to 1947.[1]

Both charts make visibly apparent the fact that except when depressed by the moves of the Commission against these and other warrants, the market prices of the warrants and the common stock generally moved together and that when the stock sold within its recent range, the normal ratio between the two was approximately one share equals 5.5 warrants.[2]

Market history shows that in 1936 the common stock sold at 17¾ and the warrants at 3¾ and in 1946 the stock sold at 15 and the warrants at 3⅜. Based on these figures the approximately 500,000 warrants outstanding would have, in the absence of the Commission's action to extinguish them, an aggregate market value in excess of $1,500,000.

Further facts, particularly the earnings forecast applicable to the Company, are set forth in the body of the argument.

Summary of Argument

The Commission's elimination of the perpetual option warrants "must be conditional upon giving the 'warrant' holders a fair equivalent in cash; and the Commission and

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[1] It is our opinion that Chart A more fairly depicts the normal relationships prevailing between the two securities than Chart B, which, by reason of the arbitrary selection of prices at particular dates, and is unduly affected by those conditions of a "temporary and speculative nature" which the Commission agrees should be excluded from consideration.

[2] A comparison of Chart B with the chart at the end of the Commission's brief, demonstrates the fact that the 5.5 factor is by no means a constant, but that the ratio itself varies with the price of the stock. That this fact is a logical result of the relationship between the two securities is pointed out in Judge Hand's opinion below (R. 123).

the company concede as much. Therefore, the only issue is whether it was permissible to appraise the 'warrants' as worthless." (Opinion below, R. 123) The Court of Appeals, per Learned Hand, C.J., correctly held that there was no "evidence 'substantial' or insubstantial to support the finding that these 'warrants' were wholly worthless." (R. 126)

The source of the Commission's error lay in its completely ignoring the significance of the fact that the warrants represent a *perpetual* option to acquire shares of the company's common stock. Their value in Judge Hand's language (R. 125), is "the result of a willingness to pay cash for the chance that the market [and the SEC's] judgment as to the future of the property may be too unfavorable." That chance is demonstrably a substantial one; and Judge Hand's conclusion from the undisputed evidence of a "long series of sales", "fortified" by "the prospective earnings of the new company", was that the Niagara Hudson Class B warrants have "substantial value". (R. 124) The SEC, although purporting to appraise the warrants, erroneously refused to "recognize" their value because it found that the common stock would not reach the call price of the warrants within the next 5 or 6 years. In other words, it arbitrarily treated *perpetual* warrants as though they were "mere short term" options. The Commission thereby shifted to the common stock a portion of the value, based on potential future increment, which this class (through the corporation) had previously carved out of its own equity and sold, for a valuable consideration, to the class of warrant holders.

Moreover, the claim of the Commission, that it does not know how to value warrants other than as short term options, cannot be taken seriously, since in *Electric Power & Light Corp.*, Holding Company Act Release No. 8889 at

70-74, aff'd, 176 F. 2d 687 (CA 2), stay denied, 337 U. S. 903, it used a fair market value formula to appraise perpetual option warrants which does justice to the perpetual call feature of such warrants and is appropriate here.

This does not mean, and the Court below did not hold, that the Commission is bound by the market price of the securities which it is its duty to value. In a reorganization where the market price reflects anticipations of the Commission's own acts, such a rule would be an absurdity. It does mean, however, that the Commission, like any other appraiser, must take into account the same factors which govern the behavior of willing buyers and willing sellers and so determine market price. The usual and approved method is to ascertain what prices similar securities normally sell for in the open market, discounting factors of a temporary, speculative nature. In order to eliminate such transient speculative factors, it is customary to take prices over a considerable period rather than on any single day. In order to determine what securities are comparable, a painstaking analysis of the earnings and asset position of the reorganized company is required, with particular emphasis on probable future earnings. These factors are considered by the Commission or other appraiser for the reason that they are the factors which govern value in the market place. It is the plain duty of the Commission as expert to put itself in the position of an intelligent and well-informed investor and to consider the evidence as he views it. Considerations of distaste or prejudice against any class or type of security must be put aside.

Thus the Commission, in appraising a preferred stock, estimates the future earnings and then computes the coverage of dividend requirements which will determine whether the stock is a prime investment or semi-speculative. It then goes to the market and ascertains whether preferred stocks

of similar quality over a reasonable and representative period of time have sold to yield 4%, 5% or 6%. With this data it is able to make a fair appraisal of the going concern value of such a preferred stock. Similarly, with a common stock, the Commission again estimates future earnings on the basis of available evidence and then goes to the market to see whether similar common stocks of other companies and in the same line of business with similar capital structures have normally been selling at ten times, fifteen times or twenty times annual earnings. The capitalization figure drawn from the market and applied to the Commission's earning forecasts determines the going concern value of the stock.

When it comes to valuation of option warrants the situation is somewhat complicated by the fact that such warrants do not produce income and so do not sell on a yield basis. Neither do they sell in the market on a times earning basis. Instead, they sell on the basis of the ratio of the price of the stock on which they are a call to the exercise or call price. Their value may thus be expressed as a fraction of the value of the stock on which they are a call. This fraction is not constant but varies with the price of the stock in such a way that the price movements of the warrants are less than those of the stock on an arithmetical basis, but more than those of the stock on a geometrical basis. Where the stock sells at or about the exercise price, such an option usually sells in the neighborhood of 40% of the stock price. Where the stock sells for half the exercise price, the option sells for a lesser fraction, usually about 20%. Where the options are unlimited in time, they never lose their market value completely, unless and until the common stock itself is wiped out. These are economic facts just like the fact that a well secured preferred stock sells to yield less than a poorly secured one. To ignore these facts and to extinguish

as worthless interests upon which the market would invariably place a substantial value, is a violation of the standards set up by Congress in the Act as interpreted by this Court and a deprivation of property without due process of law.

The Court of Appeals did not require, as it might and perhaps should have, that the Commission should follow the method adopted in the *Electric Power & Light* case, *supra*. It merely required that the appraisal be made in the light of the facts and not in their teeth. The decision is not based upon any "amorphous principles of colloquial equity" nor does it find compensable "the termination of an opportunity to make a profit by trading in otherwise worthless pieces of paper". Essentially what the Court of Appeals determined was that the Commission had not valued the warrants in accordance with legal standards. If the Commission is to have the sole right to set the standard, as well as to apply it, then it can extinguish any interest by its mere fiat.

ARGUMENT

Point I

The Court of Appeals Correctly Held That the SEC Committed Error of Law by Completely Ignoring the Perpetual Call Feature of the Option Warrants.

A. *The Rule of the Otis and Central Illinois Decisions.*

It is now authoritatively determined that, in a recapitalization proceeding under Section 11 of the Public Utility Holding Company Act, the SEC commits reversible error of law in "shifting investment values from one class of security to another by maturing contract rights which would not otherwise have matured." *SEC* v. *Central Illinois Securities Corporation*, 338 U. S. 96 (*Engineers* case); *Otis & Co.* v. *SEC*, 323 U. S. 624. The SEC has committed pre-

cisely this error. It was led into this error because it misconceived the true nature of the option warrant contract here involved, particularly its perpetual call feature.

B. *Nature of the Option Warrant Contract—the Critical Significance of the Perpetual Call Feature.*

The authorities are agreed that an "option warrant . . . represents something that has been taken away from the common stock". Graham and Dodd, *Security Analysis*, 2d Ed., 644-645; Berle and Means, *The Modern Corporation and Private Property* 151-152, 182; *Re Electric Power & Light Corp., supra* at 72; cf. *Merritt-Chapman & Scott Corp. v. N. Y. Trust Co.*, C. A. 2, decided November, 1950. The option warrant carves value out of the value of the common stock. We must, therefore, analyze the nature of the contract between the class of common stockholders and the class of option warrant holders, and in order to do so, we must first call attention to what constitutes the value of the common stock in a going concern immediately prior to the issuance of option warrants.

The common stock in a continuing enterprise represents the residual chance to make a profit (after all prior claims are satisfied). This opportunity encompasses two distinct elements: (1) anticipated earnings and (2) those earnings which cannot be foreseen but which may nevertheless eventuate. In a dynamic economy such as ours, the second is an important factor. This is brought home to us by Knight, in his classic treatise on *Risk, Uncertainty and Profit* (1921). As he points out, "Uncertainty is one of the fundamental facts of life" (346). This is intensified in a dynamic economy: "Progress involves uncertainty in a high degree" (312); and business cycles "enormously increase the uncer-

tainty of business operations", (336). Indeed, it is this phenomenon of the *unforeseeable* that produces pure profit:

> "Profit arises out of the inherent, absolute unpredictability of things, out of the sheer brute fact that the results of human activity cannot be anticipated and then only in so far as even a probability calculation in regard to them is impossible and meaningless". (311)

Only if we bear in mind the crucial fact that the value of the common stock depends on both factors—anticipated earnings and the chance that unforeseen earnings may be realized—can we understand the essential nature of the bargain made between the two classes of securities when the corporation issues stock purchase option warrants. Immediately prior to the issuance of the warrants, the market price of the common stock reflects its entire value; the value of the anticipated earnings and the value of the chance to make unforeseen earnings. What then is the bargained-for value of the warrants upon issuance at a call price *higher* than the market price of the stock? Certainly, it cannot represent any of the value inhering in the foreseeable earnings. This is fully reflected in the lower, prevailing market price of the stock. Thus, in *Ecker* v. *Western Pacific R. Corp*, 318 U. S. 448, 476, a railroad reorganization under Sec. 77, this Court, per Mr. Justice Douglas, pointed out that the "reasonable"—that is, prospective earning power of the carrier is "exhausted" by the securities, other than warrants, which it issues.

It is therefore clear that the warrants, upon their issuance at an option price exceeding the market price of the stock, reflect a portion of the second element of value, that inhering in the chance—always significant in our dynamic economy—that a going concern will realize now unforeseen earnings. As this Court put it in the *Ecker* case, *supra*,

warrants reflect a "mere possibilty" of earnings. Dewing states the point tersely: warrants constitute "the right to participate in *problematical* future profits". *Financial Policy of Corporations*, 4 ed., 1941, vol. 1, at 256 (italics added); cf. Graham & Dodd, *supra*, 1st ed., at 547 and 550.

The contract between the respective classes of common stockholders and stock purchase option warrant holders, which must be respected in Section 11 recapitalizations, should now be plain. This contract entitles the warrants to share in unanticipated earnings which, when they become foreseeable, push the market price of the stock beyond the level of the option price at which the warrants can be exercised. Immediately upon issuance the warrants then have no exercise value but are nevertheless valuable; this value, which they concededly do have at that point, has been variously named: e. g. "trading value" or "premium value" See e. g. 4 So. Calif. L. Rev. 269, 271, Wiesenberger, *Investment Companies* (1946 ed.) 95-100.

Thus the contract stands at the moment of issuance of the warrants. Let us consider the contract in operation where the issuing corporation remains a going concern. Earnings not anticipated when the warrants were issued are in fact realized or become reasonably foreseeable in amounts which enhance the value of the stock, raising it above the exercise price of the warrants. The warrants then acquire what has been called an "exercise value". But this exercise value is in addition to, and not instead of, their original value. They retain a premium value measured by their original and continuing contract right to share in further unanticipated earnings of the going concern.

This contract right continues, while the enterprise continues, so long as the option has not expired and whether or not the warrant has yet succeeded in acquiring an exercise value. A particularly significant feature of the Niagara

Hudson warrants must be noted here. They are *perpetual* options. In other words, even though they do not have a present exercise value they have a present premium value measured by their contract right to share in unanticipated earnings which may be earned at any time in the future, in perpetuity.

We take it to be conceded by the SEC that it cannot nullify either the exercise value or the premium value of warrants. In the *Electric Power and Light* case, *supra*, at 72-74, the Commission pointed out these two distinct value elements in the warrants there involved and held that it was required, in a Section 11 recapitalization proceeding, to give effect to both. On appeal to the Second Circuit, the SEC brief (27-28) summarized its position in this connection as follows:

> "As to the fairness of the participations between the holders of the common stock and the holders of the option warrants who are entitled in perpetuity to receive the shares of Electric's common stock at $25 per share, appellants contend the Commission erred in according value to the perpetual feature of the warrants. The Commission fully discussed this problem at pages 72-74 of its opinion. Appellants' contention involves a repetition of contentions rejected by the Supreme Court in *Otis & Co. v. SEC*, 323 U. S. 624, 637-638 (1945), which held that rights are not matured by operation of the Act and must be measured on a going-concern basis in order to prevent a windfall to one class of security holders at the expense of another. Accordingly, the Commission was required to give proper recognition to the right of the warrant holders to share with the common stockholders in any increment of value in excess of $25 per share of common *which might be realized at any time in the future*. This right represents an everlasting potentiality of dilution of the interests of the common stockholder, who under the *Otis* decision cannot employ the reorganization which the

> Act requires to relieve himself of this burden without fair compensation to the option warrant holder." (Italics supplied.)

This Court of Appeals, approving this reasoning, affirmed the orders of the SEC and the District Court. *Re Electric Power & Light Corp.*, 176 F. 2d 687 (CA 2). This Court refused a stay, 337 U. S. 903.

C. *The SEC Committed Error of Law by Refusing to "Recognize" the Admitted Value of the Perpetual Call Feature of the Niagara Hudson Warrants.*

The SEC was aware of the evident inconsistency between its decision in the *Electric Power & Light Corp.* case, *supra*, and its action here. In its Niagara Hudson opinion (R. 80, footnote 59), a reconciliation was attempted:

> "We recognize that the holders of the option warrants have a right to purchase common stock at any time, and that this perpetual feature has some present value no matter how remote or speculative the exercise of the right might be. The value to be accorded that right, however, in this case, is so small that as a practical matter we would not be justified in recognizing it for the purposes of a Section 11 reorganization. Cf. *Electric Power & Light Corporation*, — S. E. C. — (1949), Holding Company Act Release No. 8889.

This footnote reflects the qualification stated in the *Electric Power & Light* Findings and Opinion, *supra*, that the perpetual feature of a warrant has a value "that must be given appropriate recognition under the circumstances of this case where there is the probability of the market price of Electric's common stock exceeding the exercise price of the warrant within the foreseeable future" (74).

In other words, the SEC admits that the Niagara Hudson option warrants necessarily have value because of their

perpetual call feature, just as the Electric Power & Light warrants necessarily had value for the same reason. It takes the position, however, that it is not required to "recognize" this value unless, in effect, it can foresee that the market price of Niagara Hudson common stock will probably reach the call price within the period (whatever that may be) for which it is capable of predicting.

We assume that the SEC employs the word "recognize" in the sense of "measure". The alternative is that it is used in the same sense as in the phrase, "the United States Government did not 'recognize' the Soviet Government." The latter use, while reflecting the SEC disapproval of warrants in principle, implies a power which the Commission cannot claim.

The contention that there are values which the SEC is not called upon to measure is, however, equally untenable, at least where the alternative to measurement is extinction without compensation. It is granted that the Commission could avoid the necessity of measuring the value of the option warrants if it were willing simply to permit them to continue outstanding. Such action would be entirely unobjectionable to the respondent.

Assuming, however, that the SEC will persist in its determination that the elimination of the option warrants is "necessary" under the Act,[3] its duties are unmistakable. It must allocate to the security holder either cash or new securities which are "the equitable equivalent of the rights surrendered". *SEC* v. *Central Illinois Securities Corp.*, *supra*, at 143. If cash is given, "the question to which the Commission seeks the answer is, 'How much money would it cost the preferred stockholders to replace their securities

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[3] This determination is inconsistent with its decision to create a class of convertible stock. *Vide infra*, p. 37.

with comparable ones?' " *id.* at 144.[4] Where not cash but new securities are given, the test, while different in the details of operation, remains essentially the same. The proper procedure, in the event that it is desired to give new securities rather than cash, is simply to follow the method and formula employed in the *Electric Power & Light* case.

The SEC, in determining whether or not the option warrant holders can be allowed any participation has refused to apply the "fair equivalent" test laid down by the Supreme Court, for surely the Commission would not contend that the option holders could buy comparable securities, such as Tri-Continental warrants,[5] with the "equitable equivalent" the Niagara Plan so generously grants to the option holders.

D. *The Substantial Value of this Perpetual Right Cannot be Ignored*

The SEC has laid down a very simple test to determine whether or not a perpetual option warrant has "recognizable value": unless the common stock, at the time of the approval of the plan, is worth the option price—or very close to it—the warrant has no "recognizable value". It is this proposition which the Court of Appeals correctly found there was no "evidence 'substantial' or insubstantial to support." It is this test which the market history of these warrants *and all other warrants* unequivocally refutes.

In *Electric Power & Light Corp., supra*, the Commission employed what is the only feasible method for measuring the value of perpetual option warrants: it reviewed the market history of the common stock and the market history

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[4] Schedule II at the end of this brief sets forth the prices of the more comparable option warrants.

[5] See Schedule II, *infra*.

of the warrants and calculated the normal ratio of the two prices, at levels such as then prevailed; this ratio was then used, with an adjustment, to determine the value of the warrants. The Commission and the Court of Appeals both rejected the contention of common stockholders that the warrant holders were entitled only to the exercise value of the warrants, i.e. the market price of the stock less the option price.

The Commission takes the position, however, that the *Electric Power* test should be employed only where the value of the common stock exceeds, or at least closely approaches, the option price, this despite the fact that this test takes into full account, in its operation, the difference between the market and the option price. No reason is given for the rejection of the *Electric Power* test in other cases; the Commission simply disagrees with the standard of value which governs in the market place and has asserted the right to supersede that standard by a new one of its own creation. The market places a value on a perpetual right to buy a stock at two, three, four or five times its current market price; the Commission says it is worthless and by its *ipse dixit* undertakes to make it so.

It must be kept in mind that warrants, unlike stock, do not sell on a yield or "times earnings" basis. They are not bought for income but represent, in the words of Learned Hand, C.J., (R. 125) ". . . a willingness to pay cash for the chance that the market's judgment as to the future of the property may be too unfavorable". This chance, to be valuable, need not be "probable" in the sense of more than 50% probable—as the Commission uses the word. In the nature of things it cannot be "reasonably foreseeable", for if it were, it would be reflected in the price of the stock, which would approach the option price. By requiring, as a test of any value, a "reasonable expectation" that the mar-

ket price of the stock will exceed the option price within the "foreseeable future", the Commission denies warrant holders, *by definition*, any premium value.[6] This self-defeating test is error of law.

The ever-present possibility that "reasonable expectations" will be exceeded and the fact that so little of the future is foreseeable give premium value to the warrants. The right of the warrant holders to share in earnings not now foreseen may not be disregarded particularly where such right exists in perpetuity, because our economy is dynamic and unpredictable.

To indicate how substantial this right is, see Knight's authoritative analysis, *supra*, of the critical dependence of profit on the dynamic, the uncertain, the unpredictable. As Graham and Dodd note (*supra*, at 547), the value of warrants depends "upon the prospects of change rather than upon stability". Change limits the scope of predictability and enhances the chances of error in our forecasts. Our economy today is more subject to change, less subject to accurate, long-range predictions than ever before.

The Commission argued below that it did measure or attempt to measure the value of the warrants but found "that the value of the warrants, if any, is not susceptible of measurement by any rational basis and must be considered *de minimis*".

We do not pretend to know what a sum too small to be measurable is. If such a statement has any logical meaning, it can only be that the value of the entire class is "nominal". If it has any greater value, the SEC

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[6] What the warrant holders are to be compensated for is not "the impossibility of proving that a rational forecast is infallible" (Brief, p. 20); it is not even the not-to-be-disputed certainty that all forecasts are fallible. It is the certainty that a forecast for three or four years is not good for perpetuity.

admittedly is required to "recognize" such value and give compensation for it. The question then arises, assuming that the SEC intended to find that the entire class was worth less than 6 cents, or $6, or even $15,000,[7] is there any substantial evidence to support such a conclusion? Is the evidence to which the Commission's brief refers pertinent to such a finding?

The SEC took a great deal of testimony concerning the value of the common stock of Niagara for the present and "presently foreseeable future". It never found a value, but we understand that it does not question the current market value of about $16 per share as being very conservative. It did find that an increase in price of about 40% within the next 3 to 6 years was probable—sufficiently probable to base the terms of the conversion and call prices of the preference stock of the new company on the assumption that such a price for the common would probably be reached or exceeded (R. 76-77). The Commission simply refused, however, to predict that the price of the stock might ever increase further after the end of that 6-year period, thereby in effect converting perpetual warrants into options terminating in six years. From the proposition "We cannot predict that a price equivalent to $42.86 per share will be reached", the Commission then drew the conclusion, "Therefore a perpetual option to buy a stock at $42.86 per share is worthless!" This conclusion is a patent *non sequitur*. To give value to such an option, it is not necessary to predict that the stock *will* within any reasonable or unreasonable period reach the option price; it is merely necessary that there be willing buyers who will

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[7] In the *Electric Power & Light* case the SEC "discounted" the normal market value of the warrants by 21.7% for "speculation." A similar discount here would leave a value of about $1,200,000. Even a 99% discount would leave a value of some $15,000, which, we assume, is not "nominal."

pay for the real potentiality that the stock *may* reach the option price.

Ultimately we come down to a play on the word "probable". The arguments of the SEC go, if anything, to support the following proposition: "The probability that the market price of Niagara Hudson common stock (or its equivalent) will justifiably reach $42.86 per share within the next few years is less than 50%". Assuming, *arguendo*, the correctness of this proposition, we reject it as irrelevant to the conclusion that the value of the entire class of option warrants is "nominal". To sustain that conclusion, it would be necessary to support by substantial evidence the following proposition: "The probability that the market price of Niagara Hudson common stock (or its equivalent) will *ever under any circumstances* exceed the option price of $42.86 per share is *infinitesimal.*" But clearly there is not even a scintilla of evidence to support this proposition, nor in the nature of the facts of this case could there be such evidence.

In order to find the probability that the stock will ever exceed the option price to be infinitesimal, it is necessary to find the probability of each and every one of the following occurrences to be infinitesimal:

1. That by reason of inflation, the present general price level will ever increase by 25%.[8]

2. That the growth of Niagara Hudson which the SEC predicts for the immediate future will continue for any extended period.

3. That the Public Service Commission of the State of New York will some day give primary consideration to

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[8] That a 25% increase would be sufficient to more than double earnings; see Bauer & Gold, *Public Utility Valuation*, pp. 391-2.

reproduction cost rather than original cost in its rate-making policies.[9]

4. That many new and presently unanticipated uses for electricity and gas will be found in the future.

5. That substitution of natural for manufactured gas in the area served by the company will take place and will greatly benefit the company.

6. That atomic energy will some day be substituted for coal in the production of power, at tremendous savings to the company.

7. That the consumption of electric power will ever greatly exceed that which can be forecast with reasonable certainty today.

8. That the company will retain a considerable proportion of its earnings, which will be reflected in gradual appreciation in the value of its stock.

9. That the area served by the company will grow in population and become more heavily industrialized.

10. That the St. Lawrence waterways project will be put into effect, benefiting the area served by the company.

11. That a public authority will ever acquire the company's properties and pay anything like their reproduction cost for them.

12. That common stocks of sound growing utility operating companies will some day sell again at 20 to 30 times earnings as opposed to today's level of 12 to 18 times.

13. That Ebasco's estimates of future earnings will continue to be approximately correct.

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[9] See Bauer & Gold, *supra*, at p. 155. The public utterances of the new chairman of the P.S.C. have already substantially enhanced this possibility. See e.g. New York Times Financial Section, November 15, 1949: "Feinberg Favors Mild P.S.C. Rule. . . . Official Sympathetic with Cost Problems and Rate Increase Requests."

14. That the SEC's estimates might be overconservative in this as in practically all cases.

15. That the company will continue in business until the occurrence of any one of the foregoing.

16. That any combination of any elements of the foregoing or any other circumstances will ever raise the price of Niagara Hudson common to the option price.

It is, we submit, self-evident that the probability of the occurrence of each of the foregoing is far from infinitesimal. These are substantial probabilities.

Who can say in today's explosive international and military situation that we will not have another serious inflation, raising prices and earnings to a new plateau and even by its own effects, bringing these warrants up to an exercise value? The Commission cannot blind itself to the fact that inflation inevitably accompanies and follows war.

Indeed, warrants first became popular when we were entering the inflationary cycle of the '20s (See 4 So. Calif. L. Rev. 269), and it is a commonplace among investors that one of the important functions of the warrant from the investor's point of view, based on its contract right to share in the company's unforeseen earnings, is *to serve as a hedge against serious inflation.* We buy insurance policies to protect against all kinds of uncertainties. The prudent investor with large sums of cash on hand or invested in bonds or other fixed-income investments is glad to pay a premium for insurance against basic inflation hazards in the economy. The warrant is precisely such insurance and the substantial premium investors will pay for it—included in its normal market price—constitutes part of its investment value.

It is unnecessary to enumerate the scientific possibilities which can greatly benefit this company. The impact of atomic energy in the field of electric power is something that

no one can begin to appraise. The possibilities of general adoption of air-conditioning, radiant heating, cooking by radar range, almost universal ownership of television sets and general electrification of the railroads are already on the horizon. These possibilities are far easier of prediction than the unanticipated changes that have actually occurred, in, say, the petroleum industry.

The SEC may say "We are not required to consider these imponderables", but where, as here, investors consider them and the market places a value upon them, the SEC is not justified in rejecting that market value simply because it is incapable of weighing accurately the factors on which that fair market price is based. Unless the Commission can say that these possibilities do not exist, that these probabilities are infinitesimal, it cannot ignore and reject out-of-hand the prices which willing buyers have always been found to pay for an opportunity to profit by these possibilities and probabilities.

The SEC has attempted to shrug off the fact that these warrants and similar warrants invariably have had substantial market value by characterizing many of the purchasers as "gamblers". The Wright Brothers gambled that they could make a machine that would fly. Henry Ford gambled on the future of the automobile. The United States Government gambled on the possibility that an atomic bomb could be made. Every man who ever drilled for oil gambled on striking it. The success of none of them was "reasonably foreseeable".

The whole position of the SEC is based upon a logical absurdity. It is that any probability which is not at least 50%—or possibly very close to it—is worthless and has no "equitable equivalent". By the same token, a term insurance policy for, say, 5 years on the life of a young man is worthless because it is not "probable" that a young man will die within 5 years and, if we may be pardoned for using

a gambler's simile, only a "ticket" on the favorite in a horse race has value, because it is not "probable" that any of the other horses will win.

The SEC has urged that it is not required to take account of "vague hopes or possibilities". It would be more accurate to say that because it cannot see over the horizon the SEC concludes that there is nothing over the horizon.

Indeed, as Judge Learned Hand pointed out (R. 124) the "conclusion" that the warrants have "substantial value" is "fortified" by the only expert forecast that was made, of the Niagara Hudson earnings during the next three years.[10] Ebasco, the leading expert in forecasting utility earnings, predicted the following earnings for Niagara Hudson after preferred dividends (Findings and opinion, Table VIII, R. 66):

1949	$17,506,000
1950	19,300,000
1951	22,415,000
1952	25,297,000

Translated into earnings per existing common share these figures are equivalent to:

1949	$1.58
1950	1.68
1951	1.99
1952	2.40

Earnings of $2.40 need be capitalized at the rate of only 17.86 times to produce the option price of $42.86: A price-earnings ratio of 17.86 is certainly not out of the question

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[10] It is important to keep in mind that the record nowhere contains any estimate for earnings for the period subsequent to December 31, 1952. Accordingly, it may be inferred that the Commission's crystal ball permits it to gaze only 3 years into the future. This may account for its inability to foresee earnings greater than those for 1948 which have already been surpassed.

for a soundly financed, growing utility operating company. Much higher ratios have prevailed and, in some cases, prevail today. The SEC cannot and does not characterize Ebasco's figures as those of a pipe dreamer or a gambler. Ebasco was the Company's expert witness, whose competence was unchallenged and whose opinion is respected even by the SEC. Its testimony is the principal evidence before the SEC. *The country's foremost expert in such matters has forecast earnings which can easily sustain the option price within three years.* And there is no evidence in the record from which a contrary conclusion could be drawn.

Indeed, the SEC apparently agreed with the Ebasco forecasts of operating earnings based on past experience (R. 70). Nevertheless, it simply disregarded the only substantial evidence before it—presented by adversaries of the warrant holders—and indulged in speculation on what the New York Public Service Commission would do to restrict the company's earnings.

As we have seen, if Ebasco's projections are correct, an increase in earnings sufficient to give a value of $42.86 per old share can be anticipated by 1953, even using the rate-base (original cost) of $400,000,000 assumed by the SEC plus additional plant at cost and a return thereon of 7% to 7.2% (R. 70). Yet an ever increasing number of regulatory bodies have appreciated the necessity of using reproduction cost in computing the rate base to assure the public utility plant required in the public interest. The reproduction cost of the Niagara facilities would obviously be well in excess of $600,000,000. A 7% return on that figure would increase earnings to $3.25 per old share, which even the SEC concedes would give an exercise value to the option warrants.

It is significant to note in this connection that the SEC's predictions have always been notoriously overconservative.

See Bilyou, *A Decade of Corporate Reorganizations under Chapter X*, 49 Col. Law Rev. 456 (April 1949). Conservatism may be laudable where its aim is to prevent bankrupt corporations from returning quickly to the courts, but it should never be a means of destroying investment values in a going concern. Bilyou's compilation does not take account of the hundreds of millions of dollars of investors' money that has been lost through the Commission's pessimistic appraisals under the Holding Company Act. Other millions have been saved as a result of delays which diligent stockholder representatives have secured. For example, the common stock of *Standard Gas & Electric Co.*, of which p. 24, footnote 15 of the Government's brief [11] speaks as having been declared worthless, has happily been resurrected and today sells for $10 a share, or more than $20,000,000.

The Commission seems not to share the view of Mr. Justice Reed of this Court that "a court of reorganization guards with equal solicitude the equity of stockholders and the priority of creditors". *In re Equitable Office Building Corporation*, unreported opinion of Mr. Justice Reed, August 6, 1946, granting a stay on application of stockholders.[12]

The Commission's persistent and repeated denials of any possibility of recovery during the present inflationary boom period constitutes a dangerous blindness for which appeal to the courts has been and can be only a partial remedy. Appraisals which consistently err on the side of

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[11] The other citations in that footnote have little bearing on the issues here. The other companies named in first paragraph seem all to have been bankrupt. The cases in the second paragraph appear to have been uncontested simplifications of subsidiaries, little if any of whose common stock was in the hands of the public.

[12] While SEC in the *Equitable* case supported the stay application, it adhered to its own finding that there was no equity for the common stock. The stockholders' equity today is worth in excess of $8,000,000.

overconservatism are every bit as destructive of real values as unduly optimistic estimates. The results are particularly disastrous because the security holders affected often lose, not a part, but their entire investment.

The Government's brief (at pp. 10, 13, 26 and 34) seeks to have this Court believe that the Commission took evidence, or made a finding, on the question of whether or not there was a perceptible *possibility* that the warrants would *ever* be exercised. It took no such evidence * and made no such finding. Nowhere in its brief does it advert to such evidence or finding. As the foregoing demonstrates, the evidence is all the other way and any such finding would be completely unsupported.

In its argument the Government subtly shifts its ground to a discussion of evidence that there was not a *reasonable probability* that the warrants would be exercised *within the foreseeable future*. The SEC's confusion of these two vitally different propositions makes its whole position untenable. See *Webster's New International Dictionary* (1921):

> Probable . . . 1. Capable of being proved. *Obs.*
>
> 2. Having more evidence for than against; supported by evidence which inclines the mind to believe, but leaves some room for doubt; likely . . . "That is accounted *probable* which has better argument producible for it than can be brought against it". *South.*
>
> 3. Rendering probable; supporting or giving ground for, belief, but not demonstrating; as *probable* evidence; *probable* presumption.
>
> 4. Plausible; specious; colorable. *Obs.*

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* Cf. Footnote 10, p. 22, *supra*.

See also *Crabb's English synonymns* (Revised Ed. 1917) p. 151; "Chance, probability . . . These terms are both employed in forming an estimate of future events; but the *chance* is either for or against, the *probability* is always for a thing. *Chance* is but a degree of *probability;* there may in this latter case be *Chance* where there is no *probability.*"

E. *By Wiping Out the Perpetual Right, the SEC Has, Without Compensation, Given to One Class of Security Holders What They Sold to Another Class.*

The SEC concedes, as it must, that the test of values in Section 11(e) is different from the test ordinarily applied in bankruptcy reorganizations. The differences which the Court of Appeals found determinative of this issue in the instant case are clearly expressed by this Court in the *Otis* case. The Court said (323 U. S. at 632):

> "Furthermore, only by forced liquidation could the common stock be deprived of its *possibility* for future earnings . . . While recognizing that the common stock participation was remote, the Commission determined that in its 'over-all judgment' Power's common had a legitimate investment value . . ." (Italics added)

The Court continued, on page 633:

> "To petitioner, no distinction is to be drawn between liquidation under bankruptcy or reorganization and liquidation under the Public Utility Holding Company Act by virtue of Sections 11(b)(2) and 11(e)."

And on p. 638, the Court specifically said:

> "The reason does not lie in the fact that the business of Power continues in another form. That is true of bankruptcy and equity reorganization. It lies in the fact that Congress did not intend that its exercise of the power to simplify should mature rights . . ."

The SEC brief miscontrues the *Otis* case. The possible earnings referred to there were neither "probable" nor "reasonably foreseeable." The SEC uses these words to describe earnings which it believes can be counted upon safely.[13] The importance of the difference is pointed out in Chief Judge Hand's opinion (R. 125).

In re United Gas Corp., 58 F. Supp. 501 (D. Del.) aff'd. 162 F. (2d) 409, cited at note 12, p. 20 of the Government's brief, supports our position here, in that participation was there given to common stockholders despite a finding that "the present common's possibility of participating in earnings is extremely remote" (p. 518). The Niagara warrants are in at least as good a position as The United Gas common stock. See also discussion of the *Otis* case, *supra*. In view of that finding, and the fact that the common was "under water", Judge Leahy found there that option warrants which would give the right to purchase new stock at 22 to 33 times its current value were too remote. The option warrant holders did not appear and took no appeal. See also *American & Foreign Power Co.*, Holding Co. Act Release No. 7815, 7849 (1947).

In the *Otis* case, although the common stock was "under water", it was given a participation because its chance to share in the possible—note, not probable—future was held to have investment value. Interpreting this case the District Court said in the *Interstate Power Company* case, 71 F. Supp. 164, 168 (D. Del.) (cited at p. 24, note 15, of the Government's brief):

> ". . . It was conceded further that the possibility of the common stock acquiring value was very remote; yet, the SEC thought the common stock should have some participation even in the light of a possibility that

[13] Thus the "foreseeable" earnings of Niagara Hudson are $1.39 per common share, as against current earnings of $1.61.

> the estimate of future earnings might prove to be erroneous. On the date of the plan the company involved and the SEC hoped that many years distant the common stock would emerge from under water. In short, it was solemnly said that it was only legal cricket that the common stockholders should be given a chance to recoup, especially where the reason for the liquidation (or, i. e., reorganization) was purely fortuitous because of forced compliance with the Act and where the future condition of the new enterprise was based on a surmise; no one had prescience to envisage with exact certitude what would be the value of junior securities."

Under the *Otis* and *Central-Illinois* decisions, *supra*, the warrant holders cannot be deprived of their everlasting bundle of rights without fair compensation. To do so, as the SEC did in this case, is prematurely to foreclose their contract rights in contravention of the legal standards prescribed by the Act. Instead of protecting the warrant holders' investment, which the SEC must do under the Act, the SEC has completely ignored and destroyed it. By destroying it, the Commission, in plain contravention of the mandate of the Act, has handed over the warrant holders' property to the common stockholders—*the very contractual property which the class of warrant holders bought from the class of stockholders when Niagara Hudson issued the warrants.*

A very remote possibility was held to have substantial investment value in the *Otis* case. How then may the bargained-for, contractual, permanent right of the Niagara Hudson warrant holders to share in possible improved earnings be wholly ignored, as was done by the SEC?

While we do not concede that a class of equity securities can be wiped out in a Section 11(e) reorganization (or even in a Chapter X reorganization) where the corporation is

solvent, we need not argue this point here,[14] since the Commission has given a participation to the common stock of more than $200,000,000. The warrants cannot lawfully be deprived of the value of their contract right to acquire "a definite proportional interest in the common stock capital of the corporate enterprise." See *Merritt-Chapman Scott v. N. Y. Trust Co.*, and other authorities cited *supra* at p. 10. Where as here there is a substantial equity for the common stock, the warrant holders must be accorded their proportionate share of it. The fact that their share is less than 1% is not important in this case, where 1% amounts to some $2,000,000.

The SEC may have authority to prevent a holding company from floating warrants and also to compel the retirement of warrants already issued. But the SEC's extreme distaste for this class of of security has caused it to confuse the authority referred to with an authority it does not have —to liquidate these securities without compensation. The warrants under consideration have already been issued and lawfully traded in as valuable property. The Congress and this Court, as well as the Fifth Amendment, have forbidden destruction of such property unless compensation is awarded.

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[14] The Government's brief, at p. 24, implies that if a common stock can be wiped out, an option warrant can, *a fortiori*. Yet this does not follow; for the position of the common stock of a company which is not earning its preferred dividend is constantly deteriorating, while the position of a warrant in a company, such as Niagara, where there are retained earnings on the common stock is steadily improving.

Point II

The SEC Committed Error of Law by Failing to Apply the Appropriate Test of Value to the Option Warrants: Namely, Their Fair Market Value.

We have demonstrated that the SEC has completely ignored the perpetual call feature, thereby depriving the warrant holders of the benefit of their bargain. This is not the "fair and equitable" treatment prescribed by the Act. The SEC takes the position, however, that the only practical method of administering the provisions of Section 11 is to compensate warrant holders for their contract claim, if any, on "reasonably anticipated" earnings, giving *pro tanto* recognition to the option, but beyond this to ignore the perpetual call feature of the warrants.

In a legal sense, option warrant holders, as well as creditors and preferred stockholders, are "prior" to the common stockholders. They all have contract claims which determine the corporate residue represented by the common stock. The SEC here has treated the option warrants as if they, and not the common stock, were residual—as if the common stockholders were entitled to a certain amount (not stated) before the warrant holders' claims could be considered. It erroneously disregards the fact that the interest of the warrant holders was, at the time of their issuance, carved out of the stockholders' equity. *See supra*, p. 10, 11. Like the rest of that equity, perpetual option warrants can be extinguished only by bankruptcy or other liquidation.

Under the Act, the SEC can either: (1) leave the option warrants undisturbed, or (2) place a value on them, in dollars or in terms of a fraction of the equity which their holders share with the common stockholders. It cannot choose the second alternative, and then refuse to make the

required valuation on the ground that its ability to predict is inadequate to the task. In order to wipe out the Niagara Hudson warrants without compensation, the Commission must find as a fact, on the basis of substantial evidence, that the probability of the common stock's *ever* reaching the option price is zero. Any such finding, in this case, would be in glaring conflict with the facts.

The difficulties of appraising the Niagara Hudson option warrants are more apparent than real. The application of the method followed in the *Electric Power & Light* case is extremely simple. In Release No. 8889, at pp. 70-74, the SEC there solved the problem in a very practical and common-sense way: it held that the decisive measure of the investment value of the option warrants was their fair or normal market value.[15]

Niagara Hudson option warrants continuously had substantial market value until it was destroyed by SEC action. The record (R. 90) shows a definite historical relationship between the market prices of Niagara Hudson common and the option warrants. Although the stock has been substantially below the option price, the warrants persisted in retaining a substantial market value. As recently as 1946, when the common stock was selling for less than today's price, the warrants sold in the open market as high as 3⅜, representing an aggregate market value of almost $1,700,000. Niagara Hudson common now

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[15] The SEC made a 21% deduction there for what it called a speculative element but the SEC opinion makes clear that, in the main, the normal market value of the option warrants was deemed the fair and practical measure of their investment value for purposes of proceedings under Section 11. While the warrants in the *Electric Power* case were found to have nominal exercise value, the SEC held expressly that they also had a premium value which was entitled to recognition, and which was reflected in the market value. In fact, practically all of the substantial value accorded to the warrants there (⅓ common share) was attributed by the SEC to their premium value.

sells for close to $16,[16] or about ⅜ the exercise price. Great increases in value are no more unusual in utility stocks than in other stocks; see Schedule I at end of this brief. Indeed, the price of Niagara Hudson common stock doubled in 1949 alone and now is eighteen times its 1942 low. Under these circumstances it is plainly absurd to assert that the warrants do not have "recognizable value."

The Government takes great pains in its brief (p. 39 et seq.) to establish that the "great percentage increase" in the market price of Niagara Hudson common within the past few years does not necessarily prove that the common will repeat that performance. Needless to say, we do not contend that it does. All that is required is a further rise of less than 170% and the Government brief does not show such an increase is unlikely. We assume that the SEC does not mean that it is intrinsically unlikely that a stock selling as "high" as $16 should double or treble in value. If so, the examples of People's Gas Light & Coke, which has risen from a price of $22 a few years ago to a high of $139 this year, and of St. Louis & Southwestern common stock, which went from $1 per share a few years ago to a current level of $210, should be sufficient refutation. We note in passing that both of these companies are subject to rate regulation. We do not contend that just because the warrants once sold for $70.50 they will necessarily return to that price. We do point out that many of the factors which contributed to the volatility of Niagara Hudson stock in the past persist. Thus the common stock retains a high degree of leverage resulting from the fact that it represents only 16% of the total capitalization.[17] That the SEC recog-

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[16] Compare the 1950 "high" of 17⅛ with the 1946 "high" of 15.

[17] For the significance of this factor, see *Bauer & Gold*, op. cit. *supra*, pp. 391-2. For the 16%, see R. 75 and dissent of Commissioner McEntire at R. 92.

nizes the likelihood of further advances in the price of the common stock is evident from its own prediction of a probable rise of some 40% within the next 3 to 6 years (R. 61, 76-77). This prediction was made in spite of the Commission's purported rejection of Ebasco's estimate that earnings available for the common stock would rise more than 50% by 1952 (R. 66) and in spite of the Commission's habitual and notorious overconservatism.

The SEC errs in ignoring the simple facts that even the stocks of conservative operating companies have frequently and even regularly doubled and trebled in market value within periods of comparatively few years. It errs in assuming that the peaks and valleys that have always characterized market prices, earnings, yields and capitalization rates in the past will give place in the future to an unending, unvarying plateau. On this unrealistic, insupportable assumption alone it bases the extinction without compensation of a class of securities worth more than $1,500,000.

The market demonstrates the presence, and measures the amount of, the investment value of all warrants enjoying a perpetual option. The market recognizes and appraises the worth of warrants arising from the elementary fact that the future of a business enterprise is essentially contingent, that estimates of anticipated earnings are uncertain even as to the immediate future and do not pretend to guess at the earnings for more distant periods of time. The element of contingency is so great in our economy that the one thing we can be sure of is that no one can anticipate the long-run prospects. The SEC concedes this but fails to appreciate the consequence; namely, that since there is admittedly a chance that some day the common stock will exceed the option price and since the option will then still be in effect, the option has a current appreciable value. Of course,

there is no mathematically precise method of fixing that value any more than there is an exact process for determining any other value (Opinion below, R. 125-6).[18] Fundamentally, value is the price agreed upon by willing buyers and willing sellers. In the case of a preferred stock or any other property commanding an income, buyers and sellers will meet on a price determined primarily by earning prospects (see e. g. *People ex rel. Parklin Operating Co.* v. *Miller*, 287 N. Y. 126 (Opinion by *Lehman*, Ch. J.). It is for this reason that the SEC is permitted to use this test in appraising preferred stocks under Section 11 of the Act, *Central-Illinois* case, *supra*. In valuing option warrants, the basic objective must also be to determine what willing buyers will pay and willing sellers take for the warrants. But the test or *kind* of material evidence is necessarily other than prospective earnings in the reasonably near future that pertinent in the valuation of, let us say, preferred stocks, since option warrants—unlike preferred stocks and other securities—*do not purport to be, and are not traded in as, property now commanding an income.* Since this species of property is desired by owners for a reason other than its ability to command earnings now or in the near future, is it not the height of absurdity to

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[18] See also *Commissioner of Internal Revenue* v. *Marshall*, 125 F. (2d) 943, p. 946 (CCA 2) per *Frank*, Circuit Judge:

> ". . . The fallacy in the argument stems largely from lack of recognition of the ely character of the word 'value' . . . The truth is that it has different meanings in different contexts, even in the restricted field of 'tax law'. And there, as almost always, 'value' involves a conjecture, a guess, a prediction, a prophecy.
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> ". . . No one can foretell what changes in technology will do to the earnings of any business. Anyone who wants to eliminate uncertainties from 'value' will have a sad time getting along in this world. All aspects of living are chancey. We cannot by use of a symbol, 'value', convert the risking into risklessness, Canute restless change out of existence."

Also *Andrews* v. *Commissioner of Internal Revenue*, 135 F. (2d) 314, 317 (CCA 2).

appraise it, as did the Commission here, in accordance with whether it can now or will in the near future be able to command earnings! If a building is uniquely adapted for and wanted as a stock exchange, the courts will refuse to value it at a price that others not wanting it for this use would pay for it. *People ex rel. N. Y. Stock Exchange* v. *Cantor*, 221 A. D. 193, aff'd, w. o. opinion, 248 N. Y. 533. If a plant is uniquely adapted for and wanted as a dairy plant, the courts will not value it as though it were ordinary commercial space. *People ex rel. Sheffield Farms Co.* v. *Mills*, 82 N. Y. Sup. 2d 337. Property must be valued in the light of its appropriate uses. The SEC has applied to option warrants a test of value which ignores their essential nature and purpose. The only appropriate method in the case of option warrants is to ascertain directly what they trade for over substantial periods. Option warrants such as those here in question clearly have a substantial value when measured by the test appropriate to them, namely, their fair or normal market value.

The SEC recognized in the *Electric Power & Light* case the anomaly of valuing option warrants in terms of earnings or yield. The value of option warrants represents nothing more or less than the market's appraisal of the possibility of an increase in the value of the stock beyond the level justified by *presently* foreseeable earnings. Accordingly, the SEC in that case took market value—not just current market, but fair market value.

The instant type of appraisal is not essentially different from that which takes place under statutes requiring appraisal of the stock of dissenting stockholders on a merger. There "fair value" is considered to be not less than "fair market price." See e. g.: *Matter of Fulton*, 257 N. Y. 487, 493 (1931); *Matter of Marcus*, 273 App. Div. 725 (1st Dept. 1948), appeal denied 274 App. Div. 822.

The Commission here says that it can ignore or reject market values. But it should be noted that all of the tests concerning earnings and normal prices—earnings ratios are nothing but abstractions and generalizations from the market. The SEC cannot appraise without considering the market. When it finds that a given preferred stock should sell to yield 5%, or a given common at 12 times earnings, it judges only by a comparison with the market prices of similar preferred and common stocks. Why then is not the same test applicable here? If the SEC wishes to check the market price of the Niagara Hudson option warrants, why does it not go to the market and see what other comparable warrants normally sell for? We do not argue that the Commission is bound to accept the market price of these particular warrants; we do say that *it cannot ignore all market values of all warrants.* That is exactly what has been done. The SEC doesn't approve of warrants—it calls them "deceptive securities". Accordingly, it takes it upon itself to ignore the *undisputed fact that any perpetual option warrant, to buy any common stock at 2.65 times its current market value, always has a substantial, measurable market value.* The SEC has no more right to ignore this fact than to ignore the fact that utility preferred stocks always yield more than United States Government bonds. It is the Commission's job to find out what a value *is*, not what it would like the value to be. Otherwise it could say: "this preferred stock is so good it will sell to yield 2¼%, just like a United States Government bond." Or it could say—as it refused to say in the instant case—that a second preferred stock of Niagara Hudson is just as valuable as its first preferred stock. To say that a perpetual option to buy Niagara Hudson common at 2.65

times today's market, has no value whatsoever, or no "recognizable" value, is just as arbitary and capricious.

For Niagara Hudson's option warrant holders to replace those warrants with comparable securities will cost them at least $1,500,000. If the warrants are to be eliminated, they are entitled to that much, whether in cash or in securities. This Court, in the *Central Illinois* case, did not say the security holders should receive cash equal to what similar securities *ought to cost*. The test is what similar securities *do cost*.

The SEC can ignore temporary speculative factors influencing the markets. It cannot ignore permanent, long range market relationships, simply by saying loftily that the market in a certain type of securities is only one gambler gambling on what other gamblers might pay. If this Court approves this attitude, the SEC can ignore all market prices, simply by dubbing them "speculative". Obviously, any one who buys any stock, not intending to hold it for eternity, is speculating that when he wants to sell it, others will be willing to buy it. Otherwise, he would be a fool to buy.

The SEC may not decline to measure the true value of an option warrant by employing a novel and arbitrary test of value. It must appraise it in the same way as it is or would be appraised in a free market, unaffected by considerations introduced by the Act. It may not ignore the appraisal of a free and active market of twenty years standing. It may show why that market appraisal is out of line, by reason of abnormal or temporary conditions. But if that appraisal is in line with the price of other similar securities, it cannot be ignored.

When the SEC decides that a common stock is worth ten times a normal years' earnings, or that a well-secured preferred stock should sell to yield four and a half percent,

it does not make these figures up out of thin air. It examines the *market*, over a period of years, to determine what the capitalization rate or the yield *normally* is. If it found that the capitalization rate is normally twenty times, and applied a rate of ten times, or if it found that similar preferred stocks yielded five percent, and applied a rate of three percent, its action would be arbitrary and unenforceable. So it is here. It may not find that 2 plus 2 equals 5. Neither may it find that $1,500,000 equals 0.[19]

The SEC is ordinarily deeply concerned about market values (R. 79, footnote 52a). In this very case it was persuaded that the Class A stock allotted to the Niagara Hudson preferred stockholders would temporarily sell in the market for less than its "investment value". The Commission undertook to compensate them for this "market hardship" by approving the conversion feature of the Class A stock (R. 60). This conversion feature is of course essentially the same as the warrants they have found it necessary to eliminate as an "undue complexity" (R. 94). The complexity of course remains under the Plan; it has merely been taken away from its rightful owners, the warrant holders, who are left with nothing, and given to the preferred stockholders as a "sweetener" (R. 60, footnote 20). The injustice of this shifting of investment values is manifest.

The terms of the conversion feature attached to the Class A stock do, of course, differ from those of the option warrants. The price is lower and the right is not perpetual but expires in six years. But the question remains: If it could be done to compensate the preferred stockholders

[19] The test of normal market value, applied in the *Electric Power & Light* case, sets the value per Niagara warrant at 2/11 common share. The price of the common being $16, the value per warrant is about $3. This figure multiplied by the almost 500,000 warrants outstanding, produce $1,500,000 for the class.

for a temporary, partial loss of market value, why could it not be done to compensate the warrant holders for a permanent and total loss of market value?

We recognize that a perpetual option may be regarded as a more serious "complexity" than one for six years. Accordingly, we would not object if, in place of perpetual warrants, new warrants limited in time were to be substituted, provided that the option price were lowered sufficiently to compensate for the abbreviation.[20] To do this is clearly unobjectionable in principle, and it is the form of relief preferred by the respondent. The SEC has, however, the alternatives of giving in place of each option warrant about one-fifth of a share of common stock, or about $3 in cash.

The market value of an option warrant is determined as a fraction of the market value of the stock on which it is a call. What that fraction is depends mainly on the ratio of the price of the stock to the option price. Within a given range, the fraction is substantially fixed. It varies little from time to time, so that if the price of the stock is known, the normal price of the option warrant can be computed with surprising certainty. In the case of Niagara Hudson, while the stock is within its recent range, the normal ratio is 1 warrant equals about 2/11 share.

Chart A, at the end of this brief, gives the annual mean prices of the common stock and of the option warrants from 1932 until 1948, the last full year of trading. It shows that the normal ratio of 1 share equals 5½ warrants prevailed whenever the stock sold in its recent range, although, at current prices, a ratio of 1 to 4½ is fairer. This normal market relationship persisted in the fact of the declared hos-

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[20] Such a provision was embodied in a plan recently filed with the SEC by United Corp.

tility of the SEC until 1949[21] when the Commission announced its intention of wiping out the option warrants.

The mean figures in the Chart were taken only as being fairest and most representative; calculations based on annual "highs", justifiable from a warrant holder's point of view, would show a more favorable correlation. At the risk of "leaning over backwards," this Chart presents only the "normal" price relationships. These have been so unvarying and persistent here as to render ridiculous the Government's suggestion (Br. 34-35) that they are the result of trades between "gamblers".[22]

The Charts at the end of this brief are not intended to show that there has been any absolutely fixed relationship between the market prices of Niagara common stock and prices of the warrants. All that the Chart at the end of the Government's brief shows is that the ratio fluctuates with the price of the securities themselves.[23] But Judge Learned Hand has explained why this is so (R. 123). Surely the Commission does not seriously contend that the parallelism

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[21] The disproportionate decline in the price of the warrants which took place in 1947 may be attributed to SEC Holding Co. Act Release No. 7615, declaring the Commonwealth & Southern option warrants worthless.

[22] At this point, in footnote 19, the Government suggests an analogy between the market prices of these warrants and those of Russian Imperial Bonds. While we do not wish to be drawn into a discussion of the merits of such obligations, we consider it self-evident that in today's international situation the possibility of a change in the regime governing Russia to one more likely to honor that country's debts, while not a "reasonable expectation . . . within the foreseeable future" is a real and "rational" possibility. In any event we believe that this Court would view a taking of those securities without compensation as a violation of the Fifth Amendment of the Constitution. That the Commission's extinctions of the Niagara Hudson warrants—with their much greater prospects—is confiscatory, follows *a fortiori*.

[23] The "peak" on March 31, 1943 shown on that Chart is obviously due to temporary speculation on that date. The use of annual mean prices, instead of the prices on forty-four days, minimizes such anomalies. See p. 3, note 1, *supra*.

in the price movements of the two securities is mere coincidence. Yet this is what it must argue if it wishes to support its suggestion that the prices paid for the warrants represent gambling, pure and simple, and that the purchasers were speculators dealing in pieces of paper which they hoped later to sell to other speculators at higher prices. In footnote 20 (Brief p. 35) the Government points out in fact that there is such a connection between the market prices of the securities—that persons who were optimistic with respect to the prospects of the stock sometimes bought the warrants instead, in order to obtain a proportionately higher return in the event that their forecasts were correct. Such behavior can hardly be characterized as irrational or unfounded upon economic fact.

Whether or not those who bought the warrants did so with the intention of holding them until they could profitably exercise them, is totally irrelevant—as well as outside the record. The fact remains that the higher the price of the stock, the greater and nearer the possibility of ultimate profitable exercise of the warrants becomes; this possibility has a substantial market value even though its materialization within the "foreseeable future" may be less than a 51% probability.

Conclusion

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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Aaron Lewittes,
Counsel for Respondent.

November 25, 1950.

SCHEDULE I

Sample List of Public Utility Security Prices Which Increased by More Than Six Times in a Four-Year Period

	1942 Low	1946 High
American Cable & Radio	1 1/8	17 1/4
American & Foreign Power Com.	9/32	14 1/4
American & Foreign First Pfd.	18 7/8	129 1/4
American & Foreign 2nd Pfd.	1 1/2	44 1/8
American Power & Light $5 Pfd.	12 1/2	123 1/2
American Power & Light Com.	1/2	22 1/2
Baltimore Transit Pfd.	4	55 5/8
Central Public Utility 5 1/2/52	3/8	30 1/2
Central States 7% Pfd.	.05	166 1/2*
Central States 6% Pfd.	.03	52 3/8*
Columbia Gas	1	14
Commonwealth & Southern	3/32	5 3/4
Eastern Massachusetts St. Adj. Pfd.	2 5/8	47
Electric Bond and Share	7/8	26 3/4
Engineers Public Service	1 1/4	41 1/2
General Public Service	1/8	7 3/8
Illinois Power	5/16	39 1/2
International Hydro A	1/4	15 1/2
International Hydro Conv. Pfd.	1 1/4	73 1/2
International Power Lt. Com.	2	60
International Tel. & Tel.	1 1/2	31 7/8
Iowa Public Service	1 1/2	24 3/4
Kansas City Public Service	1/8	3
Middle West Corp.	2 3/4	31 7/8
New England Public Service $7 Pfd.	6 1/2	168 1/2
New England Public Service Com.	.10	12 1/8
Niagara Hudson	7/8	15
North American	6 1/2	39 3/4
North American Light & Power	1/16	12 1/2
Northwest Utilities 7% Pfd.	6 7/8	184
Northern States Power (Del.) A	1 7/8	73 1/2
Oklahoma Railway Inc. Bonds 1990	1/2	81
Penn Gas & Elec. A	1/8	9
Penn Gas & Elec. $7 Pfd.	1/2	50 3/4
Southern Union Gas Com.	1	42 1/2
Standard Gas $6 Pfd.	5 1/8	135 1/2
Standard Gas $4 Pfd.	3/4	60 3/8
Standard Gas Com.	5/32	8 1/4
Standard Power Pfd.	12	160
Standard Power B	1/32	7 3/4
Wisconsin Electric Power	2	23

* All entries taken from Moody's Public Utility Manual 1948 except for those asterisked which were taken from Moody's Banks and Insurance Manual 1948.

SCHEDULE II

Range of Market Prices in 1949 of Perpetual Option Warrants and Common Stock Most Comparable to Niagara Hudson Corporation.

	Terms	Stock High	Stock Low	Warrants High	Warrants Low
Merritt, Chapman & Scott	1 sh. at $30	23½	18	6	2¾
Tri-Continental	1.27 sh. at $17.76	9¾	6¼	3⅛	2⅛
*United Corp.	1 sh. at $27.50	5	2½	7/16	⅛

* Plan pending under § 11(e) of the Act.

CHART A

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ANNUAL MEAN PRICES NIAGARA HUDSON COMMON STOCK AND WARRANTS

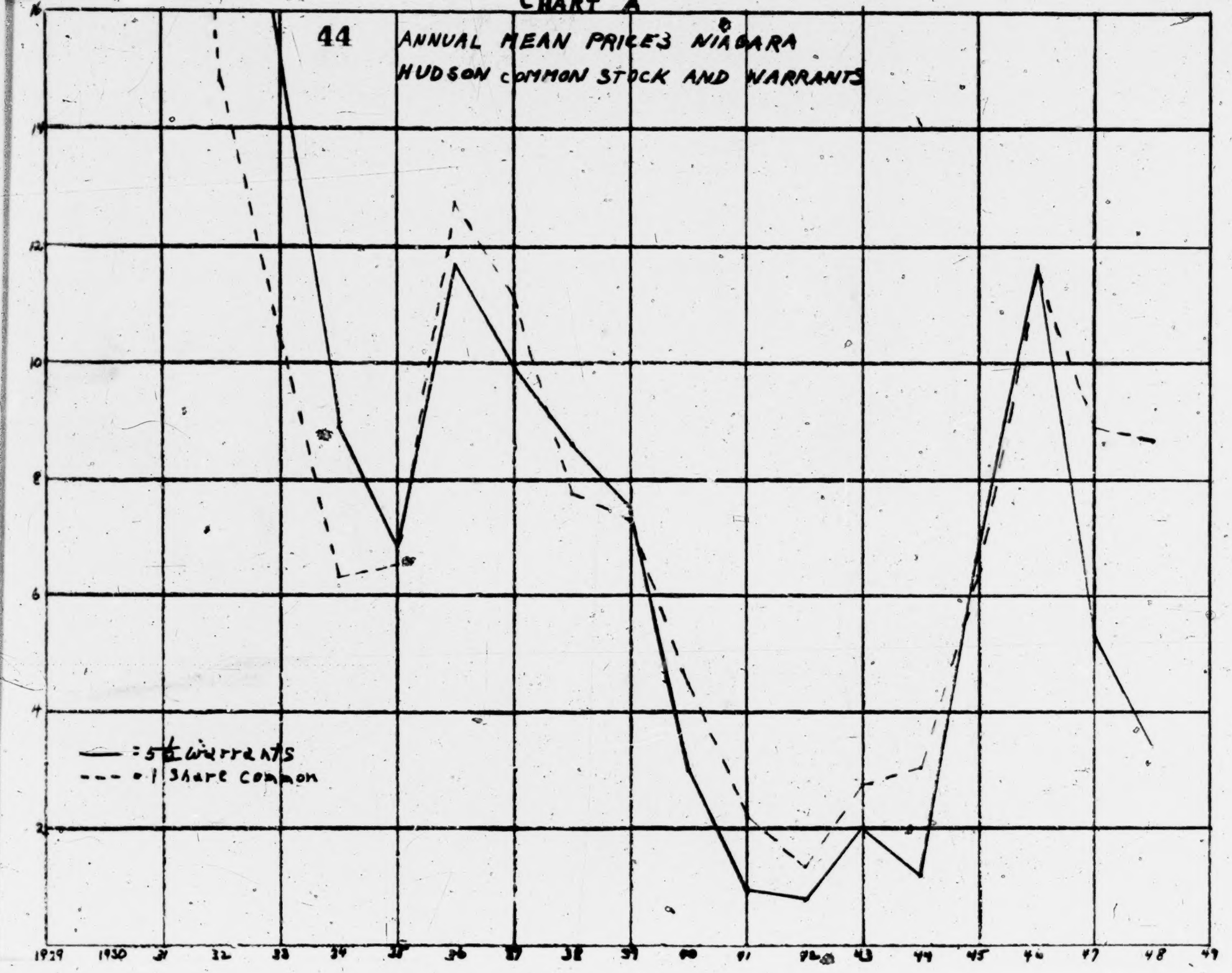

CHART B

ACTUAL MARKET PRICES NIAGARA HUDSON COMMON STOCK AND 5½ WARRANTS AT CLOSE OF EACH QUARTER YEAR, 1937-1947

COMMON STOCK ---
5½ WARRANTS ——